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No. 71

IN THE

Supreme Court of the United States

October Term, 1927

C. G. LEWELLYN, COLLECTOR OF INTERNAL REVENUE FOR THE TWENTY-THIRD DISTRICT OF THE UNITED STATES, ETC., PETITIONER

v.

ELECTRIC REDUCTION COMPANY,

On Writ of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

BRIEF FOR RESPONDENT

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BRIEF FOR RESPONDENT

Opinions Below

The opinion of the United States District Court for the Western District of Pennsylvania (R. 27-32) is reported in 8 F. (2d) 91. The opinion of the United States Circuit Court of Appeals for the Third Circuit (R. 33-36) is reported in 11 F. (2d) 493.

Jurisdiction

The judgment to be reviewed is that of the United States Circuit Court of Appeals for the Third Circuit. It was entered February 27, 1926, and is found in the Record at page 36. Petition for writ of certiorari was filed May 24, 1926, and was granted by this Court October 11, 1926, under the Judicial Code, Section 240 (a), Act of February 13, 1925.

Statute Involved

The Revenue Act of 1918 (c. 18, 40 Stat. 1057, 1077, 1078) provides:

> "Sec. 234 (a) That in computing the net income of a corporation subject to the tax imposed by section 230 there shall be allowed as deductions:
>
> * * *
>
> "(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;
>
> "(5) Debts ascertained to be worthless and charged off within the taxable year; * *"

Statement of the Case

In this case on petition a writ of certiorari was granted to review the judgment of the Circuit Court of Appeals for the Third Circuit, whereby the final judgment of the District Court of the United States for the Western District of Pennsylvania entered in favor of the petitioner was ordered reversed and a new trial granted.

The admitted facts, stated more concisely than in petitioner's brief, are set out in the opinion of the Circuit Court of Appeals, which, with a few additions by coun-

sel for respondent shown in brackets [ ], are as follows (R. 33-34):

> "On July 2, 1918, plaintiff below, Electric Reduction Company, agreed to purchase from one Jouravleff one hundred and fifty to one hundred and seventy-five tons of tungsten ore. Jouravleff was to ship a car of thirty to thirty-five tons each month beginning in August, 1918. The plaintiff was 'to establish immediately a banker's acceptance for $30,000 in favor of the seller for 60 days to cover and to be deducted from the first car shipped. A like acceptance to be issued, if necessary, on each following car.' [To cover this provision of the contract, plaintiff executed and delivered to Jouravleff a trade acceptance for $30,000, to be paid only after the first car of ore was delivered.] On August 20, 1918, Charles Hardy, who represented Jouravleff, telegraphed the Reduction Company: 'Reference contract Jouravleff shipment one car to be made today.' The Reduction Company relying upon the truth of the telegram thereupon sent [paid] its trade acceptance for $30,000 to Jouravleff. The car of ore was not shipped that day nor at any other time. However, ore to the value of $2,784.65 was subsequently shipped. Jouravleff [had] negotiated the trade acceptance to [one who claimed to be] an innocent holder for value and [to whom] so the plaintiff had to pay it at maturity. The plaintiff brought suit against Jouravleff and Hardy, who had guaranteed the payment, for the amount of his loss, $27,205.35, but they were financially [or otherwise] irresponsible. The litigation lasted until 1922, when the plaintiff charged off the amount on its books and amended its tax return for 1918. The Commissioner of Internal Revenue denied the right to charge off this loss for 1918 and assessed additional taxes, which were paid under protest. A return was demanded but was refused, and thereupon this suit

was brought. The case was tried by agreement before the court without a jury. Judgment was entered against the plaintiff.

"The question is whether or not the so-called loss comes within subdivision (4) or (5) of section 234 (a) of the revenue act of 1918. The act provides as follows:

" 'Section [2] 34. (a) That in computing the net income of a corporation subject to the tax imposed by section 230, there shall be allowed as deductions:

" '(4) Losses sustained during the taxable year and not compensated for by insurance or otherwise;

" '(5) Debts ascertained to be worthless and charged off within the taxable year.' (40 Stat. 1057) If the $27,205.35 is a 'loss' within the meaning of subdivision (a) (4), it may be deducted from the income of 1918, as it was actually 'sustained' in that year. If it was a bad 'debt' within the meaning of (a) (5), it may not be deducted from the income of that year because it was not 'ascertained to be worthless and charged off within the taxable year' of 1918.

"According to the original return the company was liable for a tax of $8,183.63. If the $27,205.35 had been allowed as a loss sustained in the year 1918, the tax for that year would have been reduced to $1,132.78."

The trial court made a specific finding of fact that (R. 30):

"19. The Electric Reduction Company was induced to pay said trade acceptance by receipt of a telegram from Charles Hardy, and in reliance thereon. Said telegram is as follows:

'August 29, 1918.

Electric Reduction Company,
Washington, Pa.

Reference contract Jouravleff Shipment one car will be made today

Hardy'

The information given in said telegram was false. No car was ever shipped."

Respondent had no income to absorb the loss after 1918, and the right to the deduction in later years as conceded by petitioner is of no real value (R. 22).

Summary of Points

(1) *The transaction in question resulted in a "loss" which comes within subdivision* (4) *of section* 234 (*a*) *of the Revenue Act of* 1918. *It was not a worthless "debt" as comprehended by subdivision* (5) *of said section* 234 (*a*).

(2) *The loss was sustained during the taxable year* 1918.

Argument

The writ of certiorari in this case was granted because petitioner represented, as is the fact, that it would be controlled by the decision of this court in the case of United States v. S. S. White Dental Company, then pending in the Supreme Court. As stated in said petition at page 2 thereof:

> "This case presents another phase of the same question involved in *United States v. S. S. White Dental Company*, No. 957, on the docket of this

> Court for the present term, in which, upon the request of the Government, a writ of certiorari was granted on April 19, 1926."

The White case was decided in favor of the taxpayer in an opinion handed down on May 16, 1927, and not as yet officially reported. This decision should, therefore, dispose, in favor of the taxpayer in the instant case, of all errors assigned with respect to the decision of the Circuit Court of Appeals below.

(1) *The transaction in question resulted in a "loss" which comes within subdivision* (4) *of section* 234 (*a*) *of the Revenue Act of* 1918. *It was not a worthless "debt" as comprehended by subdivision* (5) *of said section* 234 (*a*).

In the case of *United States v. S. S. White Dental Company*, supra, there was more reason for holding a part of the loss at issue a "debt" than in the instant case. There part of the loss was represented, as set out in the opinion of the Supreme Court, by "* * * an open account, due to respondent from the German company."

The Circuit Court of Appeals below, after discussing the distinction intended by Congress in differentiating in section 234 (a) of the Revenue Act of 1918 between a "loss" and a "debt", stated (R. 35-36):

> "Some definitions of 'loss' cover the transaction in question. The plaintiff failed to keep what it had and parted with it through fraud and misrepresentation. On the other hand, there are definitions of 'debt' which do not include this transaction.
>
> * * *
>
> "In the construction of a taxing statute doubts

should be resolved against the Government and in favor of the taxpayer. American Net & Twin Co. v. Worthington, 141 U. S. 468, 474; Benziger v. United States, 192 U. S. 38, 55; Gould v. Gould, 245 U. S. 151. It is not clear to us that the term 'losses' in subdivision (a) (4) of section 234 of the Act does not include the loss of $27,205.35. Therefore the judgment of the District Court is reversed and a new trial granted."

It is submitted that Congress used the terms "losses" and "debts" in their ordinary and accepted meaning in trade and business; that is, that "worthless", commonly referred to in trade circles as "bad" debts result from transactions originating in connection with sales, which are ordinarily recorded as accounts receivable. A bank sells money and its loans, if unpaid, constitute bad debts. A wholesaler or retailer of merchandise sells merchandise on credit, and these accounts are those subject to the bad debt charge off. The bad debt provision was intended to give credit grantors a wider latitude in annual deductions from taxable income than they would otherwise enjoy.

A loss to be deducted must be "sustained" in the taxable year. It cannot, by the exercise of any judgment on the part of the taxpayer, be shifted from one year to another. On the other hand, with respect to bad debts, a taxpayer was to be allowed to exercise, to a certain extent, his own judgment. To entitle him to charge off a bad debt, the transaction did not necessarily have to be closed. The account by its terms might not be due at the date of the charge off. Nor did he have to establish absolute uncollectibility. All that was needed was to show that, in the light of all the surrounding circumstances at the end of the taxable year, it was reason-

able to apprehend that the account could not be collected. This account might be paid in January of the succeeding year, but that fact would not affect the previous deduction.

The percentage of bad debts to the total of sales usually runs in a fixed percentage from year to year, and under the more recent revenue acts a reserve can be created to take care of bad debts. The average credit man of any business house if requested to state the percentage of bad debts for a given year, will give one based on a percentage of sales. He will not take into consideration as bad debts money paid out to purchase merchandise never delivered.

This is recognized in the brief for petitioner, because it is sought in the argument to separate the transaction in question into a purchase and the granting of credit.

> "* * * the contract for purchase and delivery of ore, was in fact treated by the parties as an independent transaction." (Brief, 8)

This is contrary to the facts, the trade acceptance itself having written in the body thereof "The obligation of the acceptor hereof arises out of the purchase of goods from the drawer," (R. 19) and the findings of fact state "* * * if said car was not shipped and delivered as agreed, the plaintiff was at liberty to refuse to pay the said trade acceptance." (R. 30)

The fact that the item was originally entered by the respondent on its books as an "account receivable" is not significant. Neither the trial court nor the Circuit Court of Appeals attached any importance to this entry. If there was a disputed set of facts to be considered, such an entry might be of some evidentiary value.

Where the facts are undisputed, it is of no importance whatsoever. Mere bookkeeping entries are not conclusive upon the Government, nor where the facts are undisputed, upon the taxpayer. This rule has been so often enunciated by this court that citation of the authorities is unnecessary.

An item must have been included in "income" to justify a charge off as a bad debt (Article 152, Regulations 45 and 62). A sale on credit (at an increase over cost) is the most common transaction, and it increases income in the year in which it is put on the books. Not so with losses, for with proper bookkeeping they do not create income. An embezzlement does not increase taxable income in the year the money is taken, and hence cannot be used as an offset to income in a later year when discovered. The deduction must go back to the year the loss was sustained. By this test the loss here at issue could never have been charged off as a bad debt.

In *Appeal of Cornelius Lumber Company*, Docket No. 4273, 5 B.T.A. 215, a transaction like the one here considered was held to be a "loss" as distinguished from a worthless debt. In that case taxpayer made advances against lumber as cut, which was to be held for future deliveries. When the lumber was shipped taxpayer was to deduct these advances from the invoice prices. The lumber company became insolvent and taxpayer found it was short 393,000 feet of lumber which it had reported as being ready for shipment and against which the taxpayer had made advances. Held, that the transaction resulted in a "loss" and that the loss was sustained in the year 1920, when the advances were made.

From the opinion of the Board (page 221):

"We are of the opinion that the taxpayer is entitled to a deduction for 1920 of $48,078.19 as a loss sustained within the year as a result of the advances made to the Sycamore Plantation Co. for lumber to be furnished by it. The taxpayer was not to be repaid the advances in money direct. Instead taxpayer was to receive lumber and, in making remittances to the Plantation Co., taxpayer, under the contract, deducted from the price at which the lumber was invoiced to it, among other sums, the amount of $30 or $35 a thousand feet, according to the grade of lumber. The contract between the parties provided that, in the event of failure of the Plantation Co. to fulfill its part of the contract, the taxpayer should take possession of all the lumber on hand and apply the same against the advances theretofore made. When the Plantation Co. became insolvent and ceased operations early in November, 1920, the taxpayer took possession of the lumber and found that it was of a value of $50,062.08. It therefore sustained a loss of $48,078.19, being the difference between the amount advanced against which the lumber was to be applied and the value of the lumber taken over."

The purpose of the Revenue Act of 1918 was to obtain for tax purposes a correct statement of net income for each year standing alone. To conclude that taxpayer's income for the year 1918 was correctly stated without giving it the benefit of this deduction is to completely disregard the real facts. To say to this taxpayer that its remedy is a charge-off in 1922, long after it had ceased to transact business and have any income, is so inequitable as to require every effort to prevent a strained construction of the Act which would perpetrate such injustice.

The construction given to Section 234-(a) (4) and (5) of the Revenue Act of 1918 by the trial court results in a distortion of the taxpayer's 1918 income. If in applying the law to the facts of this case there is any doubt as to the correct rule, then this brief may properly include a reference to the following case:

Knowlton v. Moore, 178 U. S. 41; 3 Am. F.T.R., 2684, 2698, (1900).

The issue there was with respect to death duties levied under the War Revenue Act of 1898.

Mr. Justice *White*:

> "We are therefore bound to give heed to the rule that, where a particular construction of a statute will occasion great inconvenience or produce inequality and injustice, that view is to be avoided if another and more reasonable interpretation is present in the statute."

(2) *The loss was sustained during the taxable year* 1918.

The argument of the petitioner that a loss is not sustained until the transaction is closed and completed is based upon an interpretation of the Act by the Treasury Department. The statute itself has but one requirement. The loss must have been "sustained" during the taxable year. A completed transaction within the taxable year may or may not be necessary to prove the loss was actually sustained. It frequently happens that the investigation made in a subsequent year discloses that the loss was actually "sustained" in the previous year.

Having grafted on to the Act by this interpretation a requirement not found therein, the Treasury Depart-

ment is too rigid in the enforcement of its interpretation, in that it requires that the taxpayer, seeking to charge off a loss as of any one year, conclusively demonstrate that as of December 31st of the year of the charge off there was no possibility whatsoever of ultimate recovery. It is this same engrafted, rigid interpretation of the Act that is relied upon in petitioner's brief in this case.

The case of *United States v. S. S. White Dental Company*, supra, sustains taxpayer's contention in this point. In this case the money was lost when it was paid out in 1918. Not one penny was ever recovered. In the Dental Company case there was always a possibility of recovery and in fact an ultimate recovery. The opinion of this court in that case fully covers the instant case. In fact, the petition for the writ of certiorari, as already pointed out, concedes that both cases are so alike as to make the decision in the one dispose of the other. In the White case, supra, this court said:

> "* * * The quoted regulations, consistently with the statute, contemplate that a loss may become complete enough for deduction without the taxpayer's establishing that there is no possibility of an eventual recoupment. It would require a high degree of optimism to discern in the seizure of enemy property by the German Government in 1918 more than a remote hope of ultimate salvage from the wreck of the war. The taxing Act does not require the taxpayer to be an incorrigible optimist."

Respectfully submitted,

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October 15, 1927.